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PUBLIC UTILITY COMMISSION OF TEXAS

APPLICATION OF
SOUTHWESTERN ELECTRIC POWER COMPANY
FOR AUTHORITY TO CHANGE RATES

REBUTTAL TESTIMONY OF
BRADLEY M. SELTZER
FOR
SOUTHWESTERN ELECTRIC POWER COMPANY

APRIL 23, 2021

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| <u>EXHIBITS</u> | |
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| EXHIBIT BMS – 1R | IRS Private Letter Ruling 8904008 (January 27, 1989) |
| EXHIBIT BMS – 2R | IRS Private Letter Ruling 201828010 (July 13, 2018) |
| EXHIBIT BMS – 3R | Excerpts from Dubroff, Andrew, Federal Income Taxation of Corporations filing Consolidated Returns (Sections 54.01 and 54.03) |

1 I. INTRODUCTION

2 Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS.

3 A. My name is Bradley M. Seltzer. My business address is 700 Sixth Street, N.W.,
4 Washington, D.C. 20001

5 Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL
6 BACKGROUND.

7 A. I graduated *magna cum laude* from the State University of N.Y. at Albany and then the
8 National Law Center at George Washington University where I earned my J.D. with
9 High Honors in 1978. For more than 40 years, I have been involved in the provision
10 of tax services principally to companies in various segments of the utility industry. I
11 joined the predecessor firm to Eversheds Sutherland, then known as Sutherland, Asbill
12 & Brennan, in 1978 directly out of law school, was later promoted to partner, and
13 continued in that capacity until 1997 when I joined Deloitte Tax as the U.S. and Global
14 Leader of the Energy Tax Practice. In 2016, I rejoined Sutherland as a partner and as
15 the co-Chair of the Energy Tax Practice shortly before its merger with what is now the
16 firm of Eversheds Sutherland. Throughout my career, I have provided tax services
17 primarily to electric, gas, telephone and water industry clients.

18 In fact, my first significant matter following graduation from law school was
19 the normalization dispute involving AT&T's then-subsidary Pacific Bell, the Internal
20 Revenue Service (IRS), and the California Public Utilities Commission. The dispute
21 was ultimately resolved by Congress through the enactment of the so-called

1 “consistency rules” that I will discuss below.¹ My practice has included tax planning
2 for the acquisition and transfer of business assets, operational tax planning and the
3 representation of clients in tax controversies with the Internal Revenue Service at the
4 audit and appeals levels, and at times, in tax litigation. I have often been involved in
5 procuring private letter rulings or technical advice from the IRS National Office. On
6 several occasions, I have represented one or more segments of the utility industry
7 before the IRS and/or the Department of Treasury regarding certain tax positions under
8 consideration or adopted by the federal government.

9 I have submitted written comments and have testified at Department of
10 Treasury hearings regarding legislative and administrative tax issues of significance to
11 the utility industry, including normalization issues arising from consolidated tax
12 adjustments (CTAs), interest synchronization, and deregulation of public utility
13 property, as well as the treatment of qualified decommissioning funds, and provisions
14 of the Tax Cuts and Jobs Act of 2017 (TCJA) relating to so-called bonus depreciation,
15 excess deferred taxes, and the limitations on business interest deductions under section
16 163(j) as amended by the TCJA. I am a member of the District of Columbia and
17 California Bars. I also am a member of the American Bar Association, Section of
18 Taxation where I served as a past chair of the Committee on Regulated Public Utilities,
19 and its Normalization Subcommittee, and regularly make presentations before the
20 current Energy & Environmental Tax Committee.

¹ See I.R.C. Sec. 168(i)(9)(B)(ii).

1 Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN A REGULATORY
2 PROCEEDING?

3 A. Yes. I have testified regarding tax, tax accounting and regulatory tax matters before the
4 California Public Utility Commission, the Missouri Public Service Commission, and
5 the Arizona Corporation Commission.

6 Q. DID YOU FILE DIRECT TESTIMONY IN THIS CASE?

7 A. No.

8 II. PURPOSE OF REBUTTAL TESTIMONY

9 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

10 A. The purpose of my rebuttal testimony is to respond to a portion of the direct testimony
11 of Staff witness Ruth Stark, Senior Regulatory Accountant in the Rate Regulation
12 Division (Staff) of the Public Utility Commission of Texas (Commission).
13 Specifically, my testimony addresses Staff's recommendations that the net operating
14 loss carryforward (NOLC) accumulated deferred federal income tax (ADFIT) Asset
15 (Item N) not be computed on a stand-alone basis as proposed by SWEPCO, and the
16 likely potential adverse consequences (under the normalization requirements) for
17 customers if those recommendations were adopted by the Commission. Company
18 witness David Hodgson is also filing rebuttal testimony in response to Staff's
19 recommendation on the NOLC ADFIT issue. Mr. Hodgson explains, among other
20 things, that Staff's recommended treatment of the NOLC ADFIT asset is inconsistent
21 with Texas law, which requires the Commission to determine the Company's tax
22 treatment on a stand-alone basis.

III. THE APPLICATION OF THE NORMALIZATION RULES TO THE STAND-ALONE METHODOLOGY

Q. DO YOU AGREE WITH STAFF'S "BRIEF EXPLANATION OF ADFIT AND THE IRC NORMALIZATION RULES"?

A. In general, yes, but it is incomplete.

Q. PLEASE EXPLAIN HOW IT IS INCOMPLETE.

A. Staff's testimony addresses the basic rules of normalization in effect since 1969. However, it fails to address the significance of the consistency rules enacted as part of the Surface Transportation Act of 1982 and their particular relevance in the instant case, as interpreted by the IRS in numerous Private Letter Rulings (PLRs). For regulated public utilities subject to the depreciation normalization rules, Congress specifically established certain fundamental relationships amongst four elements of ratemaking – depreciation expense, tax expense, rate base, and the reserve for deferred taxes or ADFIT.

Q. WHY IS THAT RELEVANT IN THE INSTANT CASE?

A. The delineation of these fundamental relationships establish that regulatory depreciation expense must be computed based on the property included in rate base. Similarly, regulatory tax expense is computed by applying the statutory tax rate to the regulatory depreciation expense. The difference between regulatory depreciation and tax depreciation expense on the same rate base, times the statutory maximum federal tax rate, is the amount that can be credited to the reserve for deferred taxes used to reduce rate base. Effectively, these fundamental relationships view the utility in isolation, *i.e.*, as a stand-alone entity, to avoid cross-subsidies inherent in consolidated

1 returns for investments that customers did not finance through their payments for utility
2 services.

3 Stated differently, if a consolidated approach is utilized, customers may pay
4 rates that reflect costs or benefits of other members of the affiliated group without
5 having financed those costs or benefits. The use of a stand-alone methodology ensures
6 that the utility's rates reflect its costs of service, not those of the other members of the
7 affiliated group. The IRS has concluded that "cherry picking" one of the four elements
8 without making consistent adjustments to the others is impermissible under the
9 normalization rules. See PLR 8904008 and PLR 201828010, attached as Exhibits
10 BMS-1R and BMS-2R, respectively. Moreover, while not directly relevant to this
11 proceeding, it should be noted that the Federal Energy Regulatory Commission also
12 requires income tax expense to be recorded using a stand-alone method. See Kentucky
13 Power, 69 FERC ¶62-172 (1994).

14 Q. DO YOU AGREE WITH STAFF'S ANALYSIS OF THE PLRs DISCUSSED IN THE
15 TESTIMONY OF SWEPKO WITNESS DAVID A. HODGSON IN SUPPORT OF
16 THE STAND-ALONE METHODOLOGY?

17 A. Not entirely.

18 Q. PLEASE EXPLAIN.

19 A. Staff is correct that the PLRs cited by Mr. Hodgson do not expressly address the impact,
20 if any, of payments to the utility under the consolidated group's Tax Sharing
21 Agreement. Staff is also correct that the normalization rules do not expressly require
22 that the intercompany tax payments be ignored for ratemaking purposes. Nevertheless,
23 in PLR 201718015 (Feb. 7, 2017), the IRS noted that the parent had made a tax sharing

1 payment to the utility with respect to its NOL and the IRS attached no significance to
2 that in addressing and resolving whether the taxpayer's methodology complied with
3 the normalization rules. Surely, if the payments under a tax sharing agreement must
4 be taken into account in determining the allowable Deferred Tax Asset as Staff claims,
5 the IRS could not, and would not, simply ignore the payment to the utility in its
6 analysis. I also disagree with Staff's assertion that it would be "equally consistent"
7 with the normalization rules to reduce the NOLC ADFIT by the payments received
8 under the Tax Sharing Agreement.

9 Q. CAN YOU ELABORATE?

10 A. First, as explained above, the consistency rules implicitly and effectively require use of
11 the stand-alone approach to focus exclusively on the utility when computing the four
12 related cost of service ratemaking items implicated by the normalization rules, namely
13 regulatory depreciation expense, regulatory tax expense, the reserve for deferred taxes,
14 and rate base. In failing to analyze the impact of the consistency rules on the
15 normalization analysis, Staff's assertion that its proposed methodology is "equally
16 consistent" with the normalization rules is fundamentally flawed.

17 Second, for the most part, tax sharing agreements and payments thereunder are
18 largely contractual issues governed by state law. The Internal Revenue Code does not
19 require a tax sharing agreement and the Treasury Regulations allow for a variety of
20 methods to allocate or share a tax liability among members of the affiliated group if
21 they so choose. But they serve a very limited purpose – the intercompany payments
22 may affect basis and/or earnings and profits, but the payments themselves are a
23 nonevent for tax purposes. The common parent of the group is the "taxpayer" relevant

1 to the IRS. See Treas. Reg. Sec. 1.1502-77. All members of the group are, however,
2 jointly and severally liable for the consolidated tax liability regardless of whether
3 members have paid a share of the liability to the parent or have received intercompany
4 payments pursuant to a tax sharing agreement.

5 Thus, since normalization is based on the extension of a loan from the Federal
6 Government for the deferred taxes, the IRS is entirely indifferent to whether and how
7 the group allocates tax liabilities amongst the members. Any payments made or
8 received by SWEPCO pursuant to the tax sharing agreement are simply irrelevant to
9 the normalization issue. See generally, Dubroff, Andrew, Federal Income Taxation of
10 Corporations filing Consolidated Returns, Sec. 8.01, *et. seq.* (Exhibit BMS-3R).
11 Whatever case Staff has urged for “equitable” consideration of the intercompany
12 payments under the tax sharing agreement, it does not change the fact that the payments
13 have no bearing on the normalization issue.

14 Q. ARE THERE OTHER ISSUES OF CONCERN IN STAFF’S TESTIMONY?

15 A. Yes. Staff’s testimony claims that: 1) SWEPCO has changed its method of regulatory
16 accounting; 2) to the extent SWEPCO’s proposal is accepted, it should not include
17 NOLCs subject to a prior rate proceeding (Docket No. 46449); 3) SWEPCO has not
18 notified the IRS of its concerns regarding the failure to use a stand-alone approach in
19 the prior proceeding; and 4) it has not requested a PLR to confirm its interpretation of
20 the normalization rules.

21 While partially correct, those assertions are also misleading. It is true that
22 SWEPCO did not assert that a stand-alone approach was required in Docket No. 46449.
23 Nevertheless, it is not uncommon for utilities to utilize procedures and adjustments that

1 create potential normalization concerns that are only discovered and evaluated after
2 one or more dockets have been concluded. In fact, a large contingent of utilities subject
3 to FERC jurisdiction had been incorrectly computing deferred taxes, sometimes for
4 decades and over the course of multiple rate cases, before the utilities realized that the
5 FERC-supplied template failed to incorporate the so-called normalization pro-rata
6 formula of Treas. Reg. Sec. 1.167(l)-1(h)(6) for purposes of computing the deferred tax
7 reserve. Flooded with requests to fix the violations as inadvertent errors, the IRS
8 eventually issued Rev. Proc. 2017-47 allowing a safe harbor for the taxpayers to correct
9 their respective violations provided they did so at the first next available rate case. And
10 in 2018, in recognition that such taxpayers might have difficulty reconstructing the
11 adjustments necessary to correct the erroneous methodology, especially where it had
12 been used for many years and through multiple rate cases, the IRS issued General Legal
13 Advice Memorandum (GLAM) 132120-17, clarifying that the correction can be made
14 prospectively without reversing the financial impact of the prior error.

15 Similarly, upon discovery of the potential risk of a normalization violation,
16 SWEPCO is raising its concerns in the context of the first next available rate case as
17 contemplated by Rev. Proc. 2017-47, as modified by GLAM 132120-17, and believes
18 it has demonstrated the risk of adopting Staff's recommendation.

19 Q. WHAT IS YOUR RESPONSE TO STAFF'S ARGUMENT THAT SWEPCO
20 SHOULD SEEK A PLR FROM THE IRS IF IT WANTS THE NOLC INCLUDED IN
21 THE ADFIT CALCULATION?

22 A. The request for a PLR is not necessary. Normalization is just one issue impacting the
23 broader question regarding treatment of SWEPCO's NOLC ADFIT. As mentioned

1 earlier in my rebuttal testimony, Company witness Hodgson addresses Texas law,
2 cross-subsidies, and regulatory principles that also support SWEPCO's position in this
3 case.

4 IV. SUMMARY OF RECOMMENDATIONS

5 Q. CAN YOU SUMMARIZE THE RECOMMENDATIONS YOU ARE MAKING?

6 A. The IRS has not directly addressed the exact fact pattern presented in the instant case.
7 However, adoption of Staff's consolidated approach poses a substantial risk of a
8 violation of the normalization consistency rules to the detriment of customers who
9 would no longer be able to share in the tax benefits of accelerated depreciation. By
10 cherry picking one element of the inextricably tied four prongs of normalization, Staff's
11 proposal makes acceptance of that risk imprudent. Based on the normalization rules
12 and prior PLRs, the IRS is likely to conclude that Staff's proposed adjustment violates
13 the consistency rules.

14 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

15 A. Yes, it does.

PLR 8904008 (IRS PLR), 1989 WL 593521

Internal Revenue Service (I.R.S.)
Private Letter Ruling

Issue: January 27, 1989

Section 167 -- Depreciation

167.00-00 Depreciation (Deductible v. Not Deductible)

167.23-00 Property of Certain Utilities

Section 168 -- (Repealed-1976 Act) Amortization of Emergency Facilities

168.00-00 (Repealed-1976 Act) Amortization of Emergency Facilities

In re: * * *

LEGEND:

Taxpayer = * * *

Parent = * * *

a = * * *

b = * * *

c = * * *

Commission = * * *

Board = * * *

State X = * * *

Dear Mr. * * *:

We received your request for a private letter ruling dated August 8, 1988, and all subsequently filed data. Your request pertains to the federal tax consequences of certain additions to deferred taxes, and, generally, whether a rate order that incorporates such a proposal will meet the normalization requirements of sections 167(1), 168(f)(2), and 168(i)(9) of the Internal Revenue Code. Specifically, you have asked that we rule as follows:

That Taxpayer will not be in compliance with the normalization requirements of sections 167(1), 168(f)(2), and 168(i)(9) of the Code, if it uses the so called consolidated tax savings adjustment as a reduction of rate base.

You have made the following representations:

Taxpayer, a State X corporation, was part of an overall consolidated group reorganization which included the formation of its Parent. Taxpayer is a regulated public utility principally engaged in the production, purchase, transmission, distribution, and sale of natural gas to customers in northern State X. Ratemaking and accounting related thereto for Taxpayer are under the jurisdiction of Commission. Taxpayer is a wholly owned subsidiary of Parent, and is included in the consolidated federal income tax returns filed by Parent. Taxpayer computes

income under the accrual method of accounting and its tax year is the calendar year. Approximately a companies are members of Parent consolidated group. Generally, these companies are involved in the business of finding, recovering, distributing, and selling energy resources. In part, the nonregulated losses generated by many of these companies were the result of the use of accelerated depreciation under sections 167 and 168 of the Code.

The vast majority of Taxpayer's property is public utility property within the meaning of section 167(1)(3)(A) of the Code. Taxpayer's qualifying property is subject to the provisions of sections 167(1), 168(f)(2), and 168(i)(9) with respect to normalization of depreciation deductions or normalization of cost recovery deductions, respectively, of such property. In its federal income tax returns, where applicable, Taxpayer has used accelerated methods of depreciation or the Accelerated Cost Recovery System ('ACRS'). For qualifying property acquired during calendar years b through c, Taxpayer elected the class life asset depreciation range system ('ADR') of depreciation pursuant to section 1.167(a)-11 of the Income Tax Regulations. Beginning with property additions of calendar year 1981, Taxpayer has used ACRS pursuant to section 168. On its regulated books of account and for ratemaking purposes, Taxpayer has followed the straight-line method of depreciation. Consequently, and as provided in sections 167(1)(3)(G)(ii) and 168(i)(9)(A)(ii), Taxpayer makes 'adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.' Additionally, for property subject to ADR, Taxpayer also normalizes the difference in depreciation attributable to shorter lives permitted thereunder by computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account in accordance with the requirements of section 1.167(a)-11(b)(6)(ii) of the regulations. For recovery property subject to ACRS, Taxpayer follows a normalization method of accounting as described in sections 168(f)(2) and 168(i)(9). The normalization methods of accounting, as described above, have been reflected on the regulated books of account of Taxpayer and are used for ratemaking purposes, having been authorized and approved by Commission.

Board proposed in Taxpayer's most recent rate case that d of the total income tax liability paid by Taxpayer to Parent, which was not paid to the federal government currently because of nonregulated subsidiary losses, be added to the deferred tax reserve, and thus be used to reduce the rate base of Taxpayer. This rate base reduction would have been in addition to the reduction brought about by the use of accelerated methods of depreciation. The rationale for this proposal was that Taxpayer's Parent had certain nonregulated subsidiaries which had experienced federal income tax losses, and Parent had been able to offset such tax losses in its consolidated return against the taxable income generated by Taxpayer. Board proposed that the tax effects of Parent's nonregulated tax losses be used to reduce the rate base (and therefore the revenue requirements) of Taxpayer, even though the losses themselves were not used and would not be used to increase the revenue requirements of Taxpayer. Neither the nonregulated losses nor any other aspect of the nonregulated operation were included as items in calculating Taxpayer's cost of service or rate base.

Taxpayer is of the opinion that if this amount is deducted from rate base, there would be a violation of the Code normalization rules in that there would be no consistency at the Taxpayer level between depreciation expense, tax expense, the reserve for deferred taxes, and rate base since certain items would be based on Taxpayer alone while others would be based on a combination of Taxpayer with other companies in the consolidated group. If this were determined to be violation of the normalization rules and the Taxpayer lost its right to use accelerated depreciation, the resulting decrease in cash flow would have adverse impacts on both the ratepayers and Taxpayer and would increase revenue both the ratepayers and Taxpayer and would increase revenue requirements. Commission rejected Board proposal for several reasons, one reason being that adoption of the proposal may violate the normalization requirements of the Code and related regulations. Commission did, however, direct Taxpayer to request a ruling as to the tax consequences of Board proposal.

Section 167(1) of the Code provides, in pertinent part, that in the case of public utility property, a taxpayer is entitled to use accelerated depreciation only if it uses a normalization method of accounting with respect to such

property. Section 167(1)(3)(G) defines 'normalization method of accounting' to mean a method of accounting whereby adjustments are made to a reserve to reflect the deferral of income taxes resulting from the use of different methods of depreciation for tax purposes than are used on the regulated books of account and for ratemaking purposes; for example, the use of an accelerated method of depreciation on federal income tax returns and the use of the straight-line method of depreciation for ratemaking purposes and on the regulated books of account.

Section 1.67(1)-1(h) of the regulations cover a 'normalization method of accounting' and subparagraph (2)(i) thereof sets forth the adjustments required to be made to a reserve for purposes of a 'normalization method of accounting'.

The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph [which refers to the difference between depreciation under accelerated methods, as reported on income tax returns, and a straight-line depreciation, using asset guideline class lives] for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1)(i) of this paragraph must be accounted for in such a manner so as to be readily identifiable. With respect to any account, the aggregate amount allocable to deferred tax under Section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation under subparagraph (1)(i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under Section 167(1) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under Section 167(a).

Similar provisions are contained in the regulations covering ADR; see subparagraphs (i), (ii) and (iii) of section 1.167(a)-11(b)(6) of the regulations. Section 1.167(a)-11(b)(6)(iii) provides that if a utility such as Taxpayer does not normalize properly, its ADR election will 'terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral'.

With respect to ACRS, section 168(f)(2) of the Code provides that the term 'recovery property' does not include public utility property [within the meaning of section 167(1)(3)(A)] if the taxpayer does not use a normalization method of accounting.

Section 163(i)(9) of the Code provides:

(A) IN GENERAL. — In order to use a normalization method of accounting with respect to any public utility property for purposes of subsection (f)(2) —

- (i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes; and
- (ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under Section 167 (determined without regard to Section 167(1)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

(B) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC. —

- (i) IN GENERAL. — One way in which the requirements of Subparagraph A are not met is if the taxpayer for ratemaking purposes, uses a procedure or adjustment which is inconsistent with requirements of Subparagraph (A).

(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS. — The procedure and adjustment which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection is also used for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

(iii) REGULATORY AUTHORITY. — The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i).

Section 167(1)(3)(O) of the Code provides, with minor exceptions, the same definition for the normalization method of accounting as found in section 168(i)(9)(A) above.

Section 167(1)-1(a)(1) of the regulations, in describing the scope of section 167(1), states, in part, the following: The normalization requirements of Section 167(1) with respect to public utility property defined in Section 167(1)(3)(A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation under Section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. . . .

Section 1.167(1)-1(h)(1)(iii) of the regulations, in further defining the normalization method of accounting states, in part, as follows:

‘the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (1) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. . . .

Under the provisions of section 1.167(1)-(1)(h)(1)(i) of the regulations, a taxpayer will be regarded as using a normalization method of accounting with respect to its public utility property only if it makes an annual adjustment to a reserve to record the deferral of income taxes resulting from the use of a different method of depreciation for income tax purposes than is used for ratemaking purposes.

The description of the normalization method in section 1.167(1)-1(h)(1)(iii) of the regulations provides that the amount of federal income tax liability deferred for normalization purposes involves only two variables, the depreciation deduction for ratemaking purposes on the one hand, and the depreciation deduction actually used for income tax purposes, on the other. The amount of income tax liability so deferred in a given year is, therefore, simply the product of the difference between these income tax deductions and the income tax rate in effect for that year. If Taxpayer were to introduce a variable, such as the tax benefits resulting from the tax losses of affiliates, an excess deferred tax reserve would be created which would reduce the rate base to an amount less than that needed to meet normalization requirements. Because of this, Taxpayer would no longer be regarded as using a normalization method of accounting. This kind of adjustment to the deferred tax reserve would have the same effect as the kind of adjustment to the reserve that is prohibited by section 1.167(1)-(1)(h)(2). Such an adjustment achieves a rate base deduction by an adjustment to deferred taxes that is not allowed by the above cited regulation. If tax benefits attributable to entities other than the regulated company are used in the determination of deferred taxes and such that the regulated company are used in the determination of deferred taxes and such deferred taxes are used to reduce rate base, the taxpayer will fail to comply with the normalization provisions of the Code and the regulations thereunder.

There is an additional reason why Board proposal would violate the normalization provisions. Section 167(1)(3)(G) and 168(i)(9)(A) require consistency with respect to the assumptions used for the computation of tax expense, depreciation expense, deferred taxes, and rate base of the regulated company. Under the proposed method, the benefit of tax losses of affiliates would be used for purposes of determining Taxpayer's rate base. However, loss affiliates are ignored for purposes of determining other components of Taxpayer's rate base and cost of service. In addition, the proposed method ignores the assets and transactions of the loss affiliates for purposes of computing Taxpayer's tax expense, depreciation expense, and deferred taxes. This lack of consistent assumptions violates sections 168(i)(9)(A) and 167(1)(3)(G) of the Code.

Therefore, based on your representations and our legal analysis, we rule:

That Taxpayer will not be in compliance with the normalization requirements of section 167(1), 168(f)(2) and 168(i)(9) of the Code if it uses the so called consolidated tax savings adjustments proposal, as discussed above, as a reduction of rate base.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusions in the ruling. See section 17.04 of Rev. Proc. 88-1, 1988-1 I.R.B. 7, 19. However, when the criteria in section 17.05 of Rev. Proc. 88-2 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

A copy of this private letter ruling is being sent to your authorized representative in accordance with the power of attorney on file with this office.

A copy of this ruling letter should be filed with the income tax return for the taxable year or years in which the transaction covered by this ruling is consummated.

Sincerely yours,

Charles B. Ramsey
Chief, Branch 6
Office of Assistant Chief Counsel
Passthrough & Special Industries

Section 6110(j)(3) of the Internal Revenue Code This document may not be used or cited as precedent. .

PLR 8904008 (IRS PLR), 1989 WL 593521

PLR 201828010 (IRS PLR), 2018 WL 3419375

Internal Revenue Service (I.R.S.)

IRS PLR

Private Letter Ruling

Issue: July 13, 2018

April 17, 2018

Section 167 -- Depreciation

167.00-00 Depreciation

167.22-00 Public Utility Property

167.22-01 Normalization Rules

CC:PSI:B06

PLR-132097-17

LEGEND:

Taxpayer =

X =

Parent =

State A =

State B =

State C =

State D =

Commission A =

Commission B =

Commission C =

Intervenor 1 =

Intervenor 2 =

Order 1 =

Order 2 =

Order 3 =

Case =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Director =

Dear ***:

This letter responds to Parent's request, made on behalf of Taxpayer, dated October 19, 2017, for a ruling on the application of the Normalization Rules of the Internal Revenue Code (Code) to certain accounting and regulatory procedures, as described below.

The representations set out in your letter follow.

Taxpayer is an investor-owned regulated utility incorporated in State B and State C. Taxpayer is a wholly-owned subsidiary of X, a State D limited liability company classified as a corporation for income tax purposes. X is wholly-owned by Parent. Taxpayer is a member of Parent's consolidated group that files a consolidated federal income tax return on a calendar year basis using an accrual method of accounting.

Taxpayer is engaged in the purchase, transmission, distribution, and sale of electric energy in State A and State B. Taxpayer is subject to regulation with respect to terms and conditions of services by Commission A, Commission B, and Commission C. Each of these regulators establishes Taxpayer's rates based on its costs, including a provision for a return on the capital employed by Taxpayer in its regulated business.

Taxpayer has claimed (and continues to claim) accelerated depreciation on all of its public utility property to the full extent those deductions are available under the Code. Taxpayer normalizes the federal income taxes deferred as a result of its claiming these deductions in accordance with the Normalization Rules. As a consequence, Taxpayer has a substantial balance of Accumulated Deferred Federal Income Taxes (ADFIT) that is attributable to the accelerated depreciation reflected on both its State A and State B regulated books of account. In its general rate cases, Taxpayer reduces its rate base upon which its return component was computed by its ADFIT balance.

Taxpayer has generated significant net operating losses ("NOLs") in a number of prior tax years and continues to have an NOL carryforward ("NOLC") balance. To accurately reflect the economics of this NOLC, Taxpayer has recorded a deferred tax asset ("DTA") on both its State A and State B regulated books of account. Taxpayer properly takes this DTA into account when computing the ADFIT balance by which it reduces its rate base and both Commission A and Commission B have accepted this treatment.

Prior to Year 4, Taxpayer had been a member of an affiliated group of corporations of which X was the common parent ("X Group"). The members of the X Group had, for many years, joined in the filing of a consolidated federal income tax return. By Year 3, the X Group had been under IRS audit for a considerable period of time

with respect to its federal income taxes for Year 1 through Year 2. The audit resulted in proposed adjustments, both positive and negative, to the taxable income of a number of X Group members, including both regulated and non-regulated members.

On Date 1, the IRS and X Group entered into a settlement ("IRS Settlement"). The IRS Settlement resulted in a net positive adjustment to the X Group's consolidated taxable income during the audit period which absorbed a portion of the then-existing consolidated NOLC. Of the consolidated NOLC absorbed, approximately \$a was attributable to Taxpayer. Under the tax sharing agreement for the X Group Taxpayer received approximately \$b in net payments during Date 4 and Date 5 from the X Group for use of Taxpayer's NOLC.

In Date 2, the month subsequent to the IRS Settlement being finalized, the results were recorded in the appropriate DTA accounts on Taxpayer's books and records. The recordation resulted in a reduction in Taxpayer's NOLC-related DTA. By reducing Taxpayer's DTA, this recordation increased Taxpayer's net ADFIT balance.

State A Ratemaking

On Date 7, Taxpayer filed an application with Commission A to request an increase in its retail rates for electricity. Taxpayer's application used a 12-month test period ending Date 3, with an effective date of Date 8 for the rates established in this proceeding. Thus, the test period was an historic test period. In computing its rate base, Taxpayer employed a 13-month averaging convention for all of the constituent elements, including ADFIT. During the proceeding, the proper calculation of the ADFIT balance by which rate base should be reduced became an issue in dispute.

In computing the amount of ADFIT by which rate base should be reduced, Taxpayer applied its applicable rate base convention, a 13-month average, to its monthly ADFIT balances for the test period and multiplied this amount by the State A distribution jurisdictional factor (c%). In its general rate case, Taxpayer reflected the impact of the IRS Settlement on Taxpayer's ADFIT balance as being \$d. Applying the jurisdictional factor to this ADFIT impact, Taxpayer calculated that approximately \$e was attributable to its State A electric distribution business. Since the IRS Settlement was recorded on Date 2, the last month of the test period, using the regulatory convention employed for all other elements of rate base, only 1/13th of the effect of the IRS Settlement (\$e/13 or approximately \$f) was included in the Taxpayer's calculation of the ADFIT balance by which it reduced rate base.

A third party intervenor (Intervenor 1) proposed to adjust Taxpayer's computation of ADFIT on account of the impact of the IRS Settlement. Specifically, Intervenor 1 proposed to treat the full impact of the IRS Settlement as a reduction in Taxpayer's ADFIT balance. Thus, Intervenor 1 proposed to take into account not just the \$f reduction Taxpayer reflected in its rate base calculation but an additional \$g, such that the entire jurisdictional impact of the IRS Settlement (\$e) was incorporated into rates.

On Date 10, Commission A issued Order 1 in which it adopted Intervenor 1's proposed ADFIT adjustment based on the proposition that the impact of the IRS Settlement is "known" and will continue through the rate effective period. On Date 11, Taxpayer filed a motion in which Taxpayer asserted its view that incorporating the treatment of the IRS Settlement proposed by Intervenor 1 would constitute a violation of the Normalization Rules. In response to Taxpayer's filing, on Date 12, Commission A issued Order 2 in which it directed Taxpayer to request a Private Letter Ruling ("PLR") from the Service to clarify the impact of the normalization rule within the context of Order 2.

State B Ratemaking

On Date 9, Taxpayer filed an application with Commission B to request an increase in its retail rates for electricity. This application was considered by Commission B in Case. Taxpayer's application used a 12-month test period

ending Date 6, with an effective date of Date 14 for the rates established in this proceeding. Thus, the test period was an historic test period. In computing its rate base, Taxpayer employed a 13-month averaging convention for all of the constituent elements. ADFIT was also computed by Taxpayer based on the 13-month averaging convention.

In computing the amount of ADFIT by which rate base should be reduced, Taxpayer applied its applicable rate base convention, a 13-month average, to its monthly ADFIT balances for the test period and multiplied this amount by the State B distribution jurisdictional factor ($h\%$). In basing the test year ADFIT balance on the 13-month averaging convention, Taxpayer applied the jurisdictional factor to the impact of the IRS Settlement detailed above. In its filings in Case, Taxpayer proposed that the impact of the IRS Settlement on Taxpayer's ADFIT balance should be \$i. Applying the jurisdictional factor to this ADFIT impact, Taxpayer calculated that approximately \$j was attributable to its State B electric distribution business. Since the IRS Settlement was recorded on Date 2, using the regulatory convention employed for all other elements of rate base, only 4/13th of the effect of the IRS Settlement or approximately \$k was included in the Taxpayer's calculation of the ADFIT balance by which it reduced rate base.

A third party intervenor (Intervenor 2) proposed to adjust Taxpayer's computation of ADFIT on account of the impact of the IRS Settlement. Specifically, Intervenor 2 proposed to treat the full impact of the IRS Settlement as a reduction in Taxpayer's ADFIT balance (without application of the 13-month averaging convention). Intervenor 2 characterized the proposed adjustment as "annualizing" the impact of the IRS Settlement to take into account not just the reduction Taxpayer reflected in its rate base calculation but an additional \$l such that the entire jurisdictional impact of the IRS Settlement would be incorporated into rates. Intervenor 2 indicated that while the reduction in the NOL DTA was not booked by the Taxpayer until Date 2, the NOL DTA was on the Taxpayer's books before the beginning of the test year.

Taxpayer contested this proposed adjustment asserting that its implementation would constitute a violation of the Normalization Rules. In response to Taxpayer's filings, on Date 13, Commission B issued Order 3 in which it directed that the Taxpayer to request a PLR from the Service to clarify the impact of the Normalization Rules before Commission B finally decides whether to annualize the cash that Taxpayer received on Date 2 as part of the IRS Settlement.

Taxpayer requests that we rule as follows:

Whether, the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer's ADFIT balance, and the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is acceptable under the Normalization Rules.

Law and Analysis

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods of depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A).

In order to use a normalization method of accounting, § 168(i)(9)(A) requires that a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first

and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base. This is known as the Consistency Rule.

In order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the procedures and adjustments used in ratemaking to calculate elements in rate base, depreciation expense, tax expense, and the reserve for deferred taxes. In this case, the IRS settlement has an effect on Taxpayer's ADFIT balance and the Taxpayer, along with Commission A and Commission B, agree that the settlement must be taken into account in setting Taxpayer's rates. The only question is whether the same convention used to calculate other elements of rate base, including ADFIT, a 13-month averaging convention, must also apply to calculate the effect of the IRS Settlement, or whether a different convention may apply to this element. Using the same convention would result in the consistent calculation of Taxpayer's tax expense, depreciation expense, and ADFIT as required by § 168(i)(9)(B). Applying a different regulatory convention solely to calculate the effect of the IRS Settlement would not satisfy the requirements of § 168(i)(9)(B) and the Consistency Rule.

Conclusion

We conclude that the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer's ADFIT balance, and the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is not acceptable under the Normalization Rules.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Patrick S. Kirwan
Chief, Branch 6
Office of the Associate Chief Counsel (Passthroughs & Special Industries)

Section 6110(j)(3) of the Internal Revenue Code This document may not be used or cited as precedent. .

PLR 201828010 (IRS PLR), 2018 WL 3419375

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1. *2 Taxation Of Corps Filing Consolidated Returns § 54.01*

Client/Matter: -None-

2 Taxation Of Corps Filing Consolidated Returns § 54.01

Federal Income Taxation of Corporations Filing Consolidated Returns--Second Edition > CHAPTER 54 Allocation of Liability

§ 54.01 Introduction

The consolidated return regulations represent a combination of single and separate entity treatment of consolidated groups. Consolidated taxable income (CTI) is determined by aggregating the separate income, deductions, and other items of the members of the group. Because of this aggregation, tax liability is determined only for the group as a whole. Nevertheless, the separate tax liability of the members must be determined for a variety of reasons, and the group's consolidated tax liability must therefore be allocated among its members.¹

The allocation of tax liability to a member and the amount of tax a member must ultimately pay may be affected by the Code and regulations, by agreements among the members and others, and by state law. Different tax allocations may be made for different purposes, and a member's actual liability for tax may not be the same as the amount allocated to it for such purposes as earnings and profits (E&P) or stock basis adjustments.

The issues may be divided for discussion purposes into seven general categories:

1. *Allocation to determine E&P.* Tax liability must be allocated to determine the earnings and profits (E&P) of a member, because each member deducts its tax liability in determining its E&P.² The Code and regulations provide extensive rules for allocating tax liability for E&P purposes. The basic methods are provided in *IRC Section 1552* and *Treas. Reg. § 1.1552-1*. *Treas. Reg. § 1.1502-33(d)* provides additional methods under which a member whose tax liability is reduced by losses and credits of other members may treat as additional tax liability its payments to the other members for the use of the attributes. In general, tax allocations do not affect the E&P of the common parent, because the common parent's E&P account reflects the E&P tiered up from all of the members. But allocations of E&P can affect the amount of E&P allocable to nonmember shareholders of subsidiaries. This can affect the taxation of distributions to these shareholders, and the aggregate E&P tiered up to the common parent. If payments are made in accordance with the allocations, they affect the relative values of the subsidiaries. Allocations can therefore be an important factor if nonmembers own stock in one or more subsidiaries.

2. *Allocation to determine stock basis.* Tax liability must be allocated to determine the stock basis adjustments of the members under *Treas. Reg. § 1.1502-32*, because taxes are treated as noncapital, nondeductible expenses of a member³ and therefore reduce the basis of its stock. *Treas. Reg. § 1.1502-32(b)(3)(iv)(D)* does not permit flexibility in allocating taxes for this purpose; it requires taxes to be taken into account by applying the principles of

¹ "Tax liability" as discussed in this chapter generally includes only federal income taxes, including the regular corporate income tax and, if they apply, the alternative minimum tax, the accumulated earnings tax, the personal holding company tax, and the former minimum tax for tax preferences. A broader definition of tax liability including state taxes, may be used in tax sharing agreements for purposes of determining liability for payments among the parties to the agreement.

² *Treas. Reg. § 1.1552-1(b)(2)*.

³ *Treas. Reg. § 1.1502-32(b)(3)(iii)(A)*.

2 Taxation Of Corps Filing Consolidated Returns § 54.01

IRC Section 1552 and the percentage method under Treas. Reg. § 1.1502-33(d) using 100 percent as the percentage.⁴

3 *Allocation for other tax purposes* Other income tax determinations may depend on the allocation of tax liability. In addition to the methods described above for stock basis adjustments and E&P, the Code and regulations provide methods for allocating the consolidated tax liability only to determine the "tax shown on the return" in computing additions to tax for underpayments of estimated tax.⁵ For this purpose, taxes are allocated using the method the group has elected under IRC Section 1552 and Treas. Reg. § 1.1502-33(d). Proposed regulations have been published to provide for allocation of tax liability under the alternative minimum tax. This issue is discussed in §§ 62.06, 62.07[8] and [9], and 71.02[4].

Although allocation methods are not specifically prescribed for other tax purposes, taxpayers probably are limited to the method in effect for purposes of determining E&P (and perhaps only the method in effect under IRC Section 1552)^{5 1} for other tax purposes. For example, as explained in § 54.03, the courts have required a payment of tax liability by a subsidiary to a parent under a tax sharing agreement to be treated as a dividend to the extent it exceeds the amount of the subsidiary's tax liability determined under IRC Section 1552.

Examples of other tax determinations that require an allocation of tax liability are.

(a) Each member's deductible portion of interest paid on an income tax deficiency for a prior consolidated return year, if the deficiency is paid in a subsequent separate return year.⁶

(b) The deduction for income taxes under IRC Section 545(b)(1) in computing the personal holding company tax on separate undistributed personal holding company income.⁷

(c) The amount of the taxes imposed by IRC Section 801 that affects the amount of the shareholders surplus account of a stock life insurance company, in the case of a consolidated group of life insurance companies.⁸

⁴ Under the pre-1995 investment adjustment system, basis adjustments were linked to E&P, so tax allocations under the IRC Section 1552 and Treas. Reg. § 1.1502-33(d) methods elected by the group were automatically used in determining stock basis adjustments.

⁵ Treas. Reg. § 1.1502-5(b)(3).

^{5 1} It has been held that the Treas. Reg. § 1.1502-33(d) methods cannot be used to determine the credit of a reciprocal insurance exchange. The credit is based on the tax liability attributable to the relevant business, and should not be reduced because of losses of other businesses of related corporations. State Auto. & Cas. Underwriters v. U.S., 462 F. Supp. 514 (S.D. Iowa 1978).

⁶ Koppers Co. v. Comm'r., 8 T.C. 886 (T.C. 1947), *supplemental opinion* 11 T.C. 894 (T.C. 1948), acq. 1949-1 CB 3 (subsidiary entitled to deduction only for interest accruing on the portion of the deficiency for consolidated tax attributable to the subsidiary's income).

⁷ The personal holding company tax may be imposed on *consolidated* undistributed personal holding company income (UPHCI) or on one or more members' UPHCI, depending on how IRC Section 542(b) applies to the group. In the separate computation case, the personal holding company tax imposed on the separate UPHCI of each member that is a personal holding company is aggregated in determining the group's consolidated tax liability. If the personal holding company tax is computed on a separate corporation basis, each member must deduct its allocated portion of the consolidated tax (excluding any accumulated earnings and personal holding company taxes) in computing its separate UPHCI. This requires two allocations of consolidated tax: (1) the accumulated earnings and personal holding company taxes must be excluded for purposes of computing the separate UPHCI of each separate (not consolidated) personal holding company, and (2) these two taxes must be taken into account in computing the E&P of each member.

⁸ IRC Section 815(c)(2)(B).

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4. *Allocation to determine liability for payment.* As agent for the group, the common parent files the consolidated return and pays the tax liability of the group, and generally receives any refunds with respect to the group for consolidated return years Treas. Reg. § 1.1552-1 operates on the assumption that the common parent collects from each subsidiary its share of the consolidated tax liability, and pays to a subsidiary its share of any refund. The allocation of liability for payment of taxes is an issue between the members and does not affect the rights of the Service. Under Treas. Reg. § 1.1502-6(a), each member of a consolidated group is severally liable for the entire tax liability of the group for any year for which it was a member, and under Treas. Reg. § 1.1502-77(a), the payment of a refund to the common parent discharges any liability of the Government to the other members. The sharing of consolidated tax liability among the members generally is not governed by the tax law. It is usually determined by a *tax sharing agreement* between the members, or in the absence of a formal agreement, by their practices with respect to the payment of taxes and the receipt of refunds.⁹ Tax sharing agreements are discussed in §§ 41.04[9] and 71.02[4].

5. *Determinations under state law.* The tax sharing practices of the group, and even its tax sharing agreement, may be challenged by adverse parties in a variety of circumstances. A challenger may argue, for example, that the practices of the group are not contractually binding, or are unreasonable or inconsistently applied. Generally, a subsidiary controlled by the group will not challenge the group's practices, even if they are binding, but creditors and others with a claim on the subsidiary's assets have challenged the group's tax allocation practices in the courts.¹⁰ For example, a trustee in bankruptcy for a subsidiary may demand full payment for the use of the attributes of a bankrupt subsidiary, even though the group has not elected to allocate tax liability under Treas. Reg. § 1.1502-33(d) and has not provided for payment for the use of attributes in a tax sharing agreement. Minority shareholders of a subsidiary may also sue to require the group to pay the subsidiary for the use of its tax attributes. A subsidiary's right to receive payment for the use of its attributes by a consolidated group is discussed in §§ 54.08 and 71.02[4]. Treas. Reg. § 301.6402-7 provides special rules under which refunds otherwise payable to the common parent of a consolidated group can be paid to the fiduciary of a member that is an insolvent financial institution. These rules, which govern the payment of refunds but do not affect ultimate rights under state law, are discussed in § 41.04[9][b].

6. *Allocations between buyer and seller.* If the stock of a subsidiary is sold and one or both of the parties is a consolidated group, the purchase agreement should contain detailed provisions for the allocation of tax liability in connection with the sale. For example, the agreement should specify to what extent a refund resulting from carrying back a loss into the selling consolidated group is to be shared between the loss corporation and the selling group. Typically, the purchase and sale agreement provides that it supersedes any tax sharing agreement already in place in the selling or buying group. Tax sharing agreements between buyer and seller are discussed in § 71.02[4].

7. *Determinations by regulatory authorities.* Allocation of tax liability of a consolidated group may be an issue in setting rates in regulated industries. For example, it may be a factor in determining a member's net earnings and rate of return on its investment for federal or state regulatory purposes. However, accelerated depreciation can be used for public utility property only if the tax benefits of accelerated cost recovery are normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account.¹¹ Normalization

⁹ Tax liability is separately determined for purposes of determining the amount of deferred income taxes which members of the group are required to record on their books for financial accounting purposes. However, tax liability under a binding tax allocation agreement may be a liability or a contingent liability for book purposes.

¹⁰ See, e.g., Jump v. Manchester Life & Cas. Mgmt. Corp., 579 F.2d 449 (8th Cir. 1978), aff'd 438 F. Supp. 185 (E.D. Mo. 1977) (unsuccessful action by state insurance commissioner to recover portion of refund attributable to group's use of loss incurred by bankrupt insurance company subsidiary); In re Franklin Sav. Corp., 159 Bankr. 9 (Bankr. D. Kan. Sept. 15, 1993) (tax refunds attributable to the tax liability of a subsidiary corporation deemed to be property of the parent corporation under a tax agreement supported by valid business reasons). See generally, D. Ponikvar and R. Kestenbaum, *Aspects of the Consolidated Group in Bankruptcy: Tax Sharing and Tax Sharing Agreements*, 58 The Tax Lawyer 803 (Summer, 2005). Tax sharing considerations for financially troubled consolidated groups are discussed in § 54.08 and § 74.01[2].

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effectively requires the benefits of accelerated depreciation to be retained by the public utility and not be passed on to its customers by being taken into account in fixing rates. The Service has ruled that a subsidiary would not be in compliance with the normalization requirements of a predecessor of IRC Section 168(f)(2) if it used for ratemaking purposes a consolidated effective rate of tax that was lower than the statutory rate of tax because of the use of losses incurred by non-utility members of the consolidated group ¹²

Although a tax allocation method and a tax sharing agreement may be of crucial importance if a conflict arises between unrelated persons, tax allocations among profitable, wholly owned subsidiaries may have little practical significance, and administrability may be the most important factor. In these situations, it may be desirable to choose a method that can be used for most or all relevant purposes. For example, it may be desirable to conform the method used for E&P purposes with the method required for financial reporting or investment adjustment purposes ¹³

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¹¹ IRC Section 168(f)(2)

¹² PLR 8525156 (Mar. 29, 1985). The extent to which regulatory authorities take the use of losses and other attributes of nonregulated members into account in ratemaking is beyond the scope of this treatise. Proposed Treas. Reg. §§ 1.167(1)-1(h)(7) and 1.168(i)-1, PS 107-88, 1990-2 CB 869, dealt with tax allocations among members of consolidated groups that included public utilities and that used normalization for accelerated depreciation. The regulations generally provided that tax savings from a utility's use of losses of other members of a consolidated group could not be treated as a reduction in the utility's tax expense for ratemaking purposes, but that consolidated tax savings could be treated as no-cost capital in determining rates. The proposed regulations were criticized by both sides of the controversy, and the Service withdrew them on April 25, 1991, saying that the project was closed pending congressional guidance. IR-91-57 (Apr. 25, 1991).

¹³ Treas. Reg. § 1.1502-32(b)(3)(iv)(D) provides that in determining the taxes treated as noncapital, nondeductible expenses of a subsidiary for investment adjustment purposes, the group must use the percentage method under Treas. Reg. § 1.1502-33(d)(2) with 100 percent as the percentage.



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1. 2 Taxation Of Corps Filing Consolidated Returns § 54.03

Client/Matter: -None-

2 Taxation Of Corps Filing Consolidated Returns § 54.03

Federal Income Taxation of Corporations Filing Consolidated Returns--Second Edition > CHAPTER 54 Allocation of Liability

§ 54.03 Effects of Method of Allocation Adopted by Group

[1] General Rules

IRC Section 1552 provides the rules for the effect of the allocation of consolidated tax liability. The tax liability allocated to a member under IRC Section 1552 decreases the member's E&P, and it is treated as a liability of the member. If a member does not pay the full amount of its liability, the amount not paid is generally treated as a distribution with respect to stock (e.g., a dividend), a contribution to capital, or both, unless the payment by another member is a loan to the owing member.²² For example, if a parent corporation pays its subsidiary's share of the consolidated tax liability and the payment is not in fact a loan, the parent is treated as making a contribution to the capital of the subsidiary. If a subsidiary pays its parent's share of the tax, and the payment is not a loan, the payment is ordinarily treated as a dividend or other distribution with respect to the subsidiary's stock.²³ If one subsidiary pays another subsidiary's tax liability, the paying subsidiary is treated as making a

²² Treas. Reg. § 1.1552-1(b)(2) and (f).

²³ Cf. Rev. Rul. 73-605, 1973-2 CB 109, Beneficial Corp. v. Comm'r, 18 T.C. 396 (T.C. 1952), *aff'd per curiam*, 202 F.2d 150 (3d Cir. 1953) (amounts paid to parent in excess of tax allocation were dividends, even if paid under a tax allocation agreement); Dynamics Corp. of Am. v. U.S., 392 F.2d 241, 183 Ct. Cl. 101 (Ct. Cl. 1968) (same). In a second *Dynamics* case, a repayment by a parent of a portion of the constructive dividend was held to be a deductible expense for the year of repayment to the extent the amount of the repayment was previously includible in the parent's income for a separate return year, net of the dividends-received deduction. The dividend had originally been made in the year following the last consolidated return year, but part of it was required to be repaid as a condition of settlement of a stockholder's derivative suit. The Court of Claims held that the payment related back to the original transaction. Dynamics Corp. of Am. v. U.S., 449 F.2d 402, 196 Ct. Cl. 282 (Ct. Cl. 1971). The deduction for repayment was, in effect, limited to the amount includible in the parent's income (net of the 85-percent dividends-received deduction) based on the tax benefit approach applied in U.S. v. Skelly Oil Co., 394 U.S. 679 (1969). If the constructive dividend had been in a consolidated return year, the repayment would not have been deductible.

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distribution to its parent, and the parent is treated as making a contribution to the capital of the subsidiary whose tax liability was paid ²⁴

Even if there is an intercompany agreement that provides for the allocation of consolidated tax liability in a different manner, the method in effect under IRC Section 1552 and, if applicable, Treas. Reg. § 1.1502-33(d) must be used in determining the E&P of the members ²⁵ The Tax Court has held that, although an accrual-basis subsidiary paid its parent an amount in excess of its allocated tax liability to compensate its parent for the use of its losses in the consolidated return, and the payment was characterized as a dividend in the return, the payment did not increase the parent's E&P for the year, for which a subsequent Service examination resulted in additional tax liability allocable to the subsidiary in the amount of the payment to the parent ²⁶ The Court held that the reduction in E&P caused by the additional tax related back to the year the subsidiary accrued the liability.²⁷ However, the Fifth Circuit Court of Appeals reversed the Tax Court's decision, holding that the form of the payment to the parent—a dividend—was controlling ²⁸ Under this disposition of the case, the Court did not find it necessary to determine the effect of the subsequently determined tax liability on the E&P of the parent corporation for the year of the distribution to the parent.

Treas. Reg. §§ 1.1552-1 and 1.1502-33(d) apply only to the group's federal income tax liability for a consolidated return year as determined under Treas. Reg. § 1.1502-2 This includes the regular corporate income tax and, if applicable, the accumulated earnings tax, personal holding company tax, and the former minimum tax for tax preferences ²⁹ In December 1992, the Service issued proposed regulations that would

²⁴ Treas. Reg. §§ 1.1552-1(f) and 1.1502-33(d)(6), Examples 1 and 2. See Rev. Rul. 73-605, 1973-2 CB 109 In PLRs 8345008 (Aug. 5, 1983) and 8344013 (July 17, 1983), the Service ruled, relying in part on Rev. Rul. 73-605, 1973-2 CB 109, that payments to a subsidiary organized in the U.S. and resident in the United Kingdom, by U.K. affiliates, for the use of the subsidiary's losses were treated as capital contributions under IRC Section 118 This caused the payments to be excluded from the subsidiary's U.S. taxable income

In PLR 8524043 (Mar. 18, 1985), considered in GCM 39367 (Dec. 31, 1984), the Service ruled that for U.S. tax purposes payments between related foreign corporations made pursuant to foreign laws permitting consolidated tax computations and intended to compensate one member for use of its losses which reduced another member's foreign tax liability should be characterized as (1) dividends, if paid by a subsidiary to its parent, (2) contributions to capital, if paid by a parent to a subsidiary, or (3) dividends followed by capital contributions, if paid from one subsidiary to another.

But the Service ruled in PLR 200515004 (Dec. 9, 2004) that the "group relief payments" to be made by one foreign subsidiary of a U.S. affiliated group to another foreign subsidiary for the use of a foreign net operating loss will be nontaxable stock distributions under IRC Section 305(a) and not includible in income by the shareholder(s) of the paying subsidiaries as dividends under IRC Section 301(a), where the group relief payments were to be made pursuant to contracts (enforceable under local law) between the foreign subsidiaries and certain members of the U.S. affiliated group that obligated the shareholder of the paying foreign subsidiary to make an immediate capital contribution to the recipient foreign subsidiary equal to the group relief payment.

²⁵ Rev. Rul. 76-302, 1976-2 CB 257. Similarly, to determine stock basis, the method required by Treas. Reg. § 1.1502-32(b)(3)(iv)(D) must be used

²⁶ Singleton v. Comm'r, 64 T.C. 320 (T.C. 1975)

²⁷ Id. at 329.

²⁸ Singleton v. Comm'r, 569 F.2d 863 (5th Cir. 1978), rev'g 64 T.C. 320 (T.C. 1975), cert. denied, 439 U.S. 940, 99 S. Ct. 335, 58 L. Ed. 2d 335 (1978) (with separate and dissenting opinions). Cf. PLR 200225032 (Mar. 20, 2002) (payments in excess of tax liability of foreign entity treated as dividends)

²⁹ Treas. Reg. § 1.1552-1(b)(1); T.I.R. 1032 (Mar. 19, 1970)

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provide a method for determining the amount of consolidated alternative minimum tax to be allocated to members of the group.³⁰ The alternative minimum tax is discussed in § 61.06.

In the absence of unusual circumstances, tax-sharing payments among members are treated as contributions or distributions and not as items of income or deduction.^{30 1}

[2] Payment Treated as a Loan

Whether a loan is created by one member's payment of another member's tax liability is a question of fact. If repayment is customarily made or is contractually agreed upon, a loan is created. If a method is elected under Treas. Reg. § 1.1502-33(d) that results in a liability to a loss member by another member for all or part of the tax benefit derived from the use of losses, a receivable and a payable arise at the close of the year of the allocation.³¹

If there is an obligation to make the repayment, the obligation would continue even if one of the parties leaves the consolidated group, and the tax consequences of subsequent events affecting the obligation should be determined under general tax principles. The debt is treated as satisfied and reissued under Treas. Reg. § 1.1502-13(g) when one of the parties leaves the group. If the creditor is unable to collect the debt and it becomes worthless, a bad debt deduction should be available. If the debt is forgiven, it may be treated as satisfied under Treas. Reg. § 1.1502-13(g). Treas. Reg. § 1.1502-13(g) is discussed in Chapter 33.

If there is no contractual obligation to make the repayment, payment of the tax liability in a manner different from the tax allocation method generally results in a dividend or contribution to capital at the time the payment is made. But if a tax payment would otherwise be regarded as a dividend or contribution to capital at a time

³⁰ *Prop. Treas. Reg. § 1.1552-1(g)*, IA-57-89, 1993-1 CB 799.

^{30 1} This can also be true for payments between unrelated persons, as in the case of transfers of income and tax sharing payments under the Alaska Native Corporation regime of prior law, under which Alaska Native Corporations could in essence apply their losses against income of unrelated taxpayers and share in the tax savings. Correspondingly, repayments of these benefits were not deductible. See TAM 200048013 (Aug. 17, 2000).

³¹ In Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901 (DC 1990), a parent corporation entered into a tax sharing agreement with its wholly owned subsidiary. Both were members of a consolidated group. The agreement required the profitable subsidiary to make quarterly payments to the parent, which had substantial NOLs, in an amount equal to the subsidiary's stand-alone tax liability. This tax liability was calculated under GAAP as used for financial accounting purposes. If the calculations were made using tax accounting principles, the subsidiary would have owed no taxes on a stand-alone basis. The court found that the effect of this tax sharing arrangement was to improperly strip cash from the subsidiary. In holding that the payments were unlawful loans to the parent, the court suggested that a tax sharing agreement requiring payments by a profitable member to a member with NOLs in excess of actual stand-alone tax liability is improper. However, the percentage method, discussed below, permits this result in some circumstances. Cf. In re Franklin Sav. Corp., 159 Bankr. 9 (Bankr. D. Kan. 1993).

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when the members are no longer affiliated, such a payment may be considered as additional gain or loss on the sale of stock of the subsidiary, or some other form of income or deduction³²

[3] Carrybacks and Carryovers

The carryback of a net operating loss, a net capital loss, or a credit causes an adjustment of the E&P for the taxable year *from* which the loss or credit is carried, but the effect of the carryback is determined by reallocating the tax liability for the taxable year *to* which the loss or credit is carried³³ For example, if a consolidated net operating loss is carried back from Year 2 to Year 1, the original allocation of the Year 1 consolidated tax liability is recomputed (in accordance with the method of allocation used in Year 1) after giving effect to the carryback, but the changes in the Year 1 tax liability are reflected in the E&P of the appropriate members using the accrual basis in Year 2. For a cash-basis member, the adjustment to E&P presumably occurs in the year the carryback refund is actually received

Treas. Reg. §§ 1.1502-21, 1.1502-78 and 1.1502-79 provide rules for carrybacks and carryovers from separate return years to consolidated return years and vice versa Under these provisions if a subsidiary leaves a group and later has a net operating loss that may be carried back to a year of that group, the refund is made directly to the group's common parent and not to the subsidiary (or to the group it is in for the loss year). The regulations do not provide a method for the subsidiary or its current group to receive the refund directly from the government³⁴ For this reason, if a group sells a member, the contract should provide specifically for the

³² However, the Tax Court has held that payments exceeding a former member's allocable share of consolidated tax liability are nondeductible taxes because each member is "jointly and severally" liable for the entire consolidated tax. *Globe Prods. Corp. v. Comm'r*, 72 T.C. 609 (T.C. 1979), acq. on another issue, 1980-1 CB 1 (deficiency paid under a tax sharing arrangement between former subsidiaries of an insolvent parent) The court apparently did not consider *Treas. Reg. § 1.1552-1(b)(2)*, which specifically mandates that the additional payment is treated as a liability of the member for whom the payment is made Failure to pay back the liability should therefore have resulted in a bad debt deduction to the paying corporation Although IRC Section 1552 and *Treas. Reg. § 1.1552-1* deal primarily with rules for E&P computations, the tax characterization of the excess payment as a liability probably should have been accepted by the court because payment of the former member's share of tax should reduce E&P without regard to how the payment is characterized. See also *Merit Tank & Body, Inc. v. Comm'r*, 40 T.C.M. 368 (T.C. 1980) (erroneous excess payment during consolidation).

Under the entitlement rule of *Treas. Reg. § 1.1502-13(f)(2)(iv)*, if a member disposes of a share of stock of another member after a distribution has been declared, but before the distribution has been made, the distribution is deemed to be made for all Federal income tax purposes when the member becomes entitled to the distribution. Arguably, an obligation under a tax sharing agreement could be equivalent to the declaration of a dividend The entitlement rule is discussed in *§ 32.02[2]*

³³ *Treas. Reg. § 1.1552-1(b)(1)*. See *Rev. Rul. 74-423, 1974-2 CB 289*, concerning the effect on E&P of a refund of prior years' taxes resulting from a net operating loss carryback attributable to a newly formed subsidiary. In *Rev. Rul. 75-153, 1975-1 CB 106*, the Service ruled that current E&P is adjusted for the total amount of refunds resulting from the carryback of a net operating loss arising in the current year which, when carried back, generated an unused investment credit that could also be carried back and absorbed in a prior year.

³⁴ However, one case, citing the last sentence of *Treas. Reg. § 1.1502-77(a)*, held that the Service may deal directly with a subsidiary In an unreported case, *U.S. v. Bass Fin. Corp.*, Docket No. 83 C 706, (N.D. Ill., May 27, 1983), the Service was permitted to turn a refund owed to a group over to the district court so that the common parent and the Federal Savings and Loan Insurance Corporation as receiver for the former subsidiary could litigate between themselves their claims to the tax refund at issue The district court noted that the Service had not decided by regulation which entity should ultimately receive the refund where both the common parent and the former subsidiary claim the right to the refund However, it noted that *Treas. Reg. § 1.1502-77(a)* is procedural in purpose and exists for the convenience of the government, citing *Jump v. Manchester Life & Cas. Mgmt. Corp.*, 579 F.2d 449 (8th Cir. 1978), aff'd 438 F. Supp. 185 (E.D. Mo. 1977) Rather than paying the refund directly to the parent, the court held that the Service could interplead the refund and let the parent and the receiver for the subsidiary litigate their right to the refund on the merits. See also IRC Section 6402(j) and *Treas. Reg. § 301.6402-7*, discussed in § 14.08, for the ability to pay a refund attributable to an insolvent member to a statutory or court-appointed fiduciary

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disposition of any refunds that arise from the carryback of losses or credits. For a discussion of tax sharing agreements in connection with the acquisition or disposition of a subsidiary, see § 71.02[4]

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